

ECONOMIC OUTLOOK

Chamber of Commerce of the United States

May 1985

BUSINESS INVESTMENT STILL THE MAINSTAY OF OVERALL ECONOMIC ACTIVITY

by

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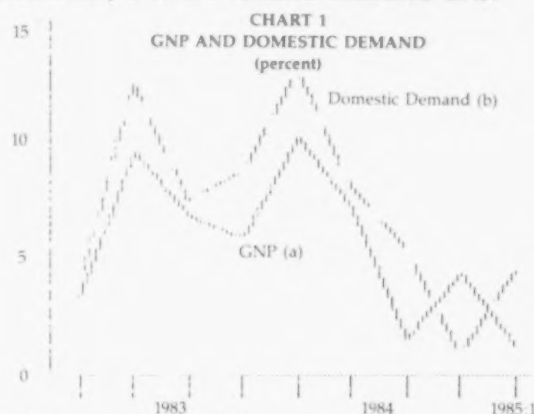
The anemic growth rate in real GNP during the first quarter makes the final resolution of the budget impasse all the more imperative. We can no longer afford to waste time; the problem of runaway federal spending growth needs to be addressed in an effective manner, one which will lay the groundwork for a continuation, and indeed, a strengthening, of the more than two years of economic expansion that we have, so far, enjoyed. This article presents a detailed discussion of the strengths and weaknesses now apparent as the business expansion continues through its third year. Our forecast still foresees a continuation of stable, noninflationary growth in the nation's economy. However, less welcome alternatives have become increasingly likely, as the article that follows explains.

Accounting for Recent Economic Performance

The first quarter posted the lowest rate of growth in economic activity since the recovery began, a development that we, as well as other forecasters, failed to fully anticipate. However, the reported measure of real GNP hides some of the economy's strengths. The real picture begins to emerge only when overall GNP is disaggregated by components. Then we see that the real problem during the past three quarters has been the extreme volatility of imports. Real imports rose at a seasonally adjusted, annual rate of 55.4 percent in the third quarter of 1984. This was followed, in the fourth quarter of 1984, by a 28.3 percent decline in the growth rate; and, in the first quarter of 1985, by a 26.2 percent increase. Excluding net exports from real GNP shows that domestic demand remained strong, rising by 4.4 percent during the first quarter. Chart 1 shows the discrepancy between the growth rates of real gross national product and GNP minus net exports since 1983. While this gap shows the extent to which imports have sapped U.S. growth, it also shows that domestic demand has been, and remains, fairly healthy, surpassing

GNP growth in every quarter, with the exception of the last quarter of 1984.

Other components of real GNP have continued to grow at a fairly strong rate. In particular, real consumer spending rose by 4.7 percent in the past quarter, the highest growth rate in three quarters. Similarly, investment in nonresidential structures rose by 16.2 percent, the fifth double-digit increase in the past six quarters. However, the remaining three components of GNP—residential investment, equipment investment, and government purchases—did post declines. Inasmuch as we believe that the rate of growth in federal outlays needs to be curtailed, the 0.9 percent decline in government purchases of goods and services during the first quarter is a welcome occurrence, even if it reduced measured GNP.



- (a) Quarterly growth rate in real gross national product, at an annual rate.
(b) Quarterly growth rate in real gross national product minus real net exports, at an annual rate.

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Nevertheless, first quarter activity would have been stronger if monetary policy had been held to a steadier course. The nation's money supply, as measured by M(1), rose by three percent between January and June 1984, but then decelerated to a growth rate of only 1.2 percent between June and November of 1984. Because growth in the money supply leads growth in nominal GNP by six to eight months, the deceleration in money supply growth between June and November of last year, was reflected in the very weak rate of economic growth registered during the first quarter of this year. Fortunately, relatively stronger money supply growth has resumed—M(1) rose by 3.3 percent between November 1984 and March 1985—presaging a resumption in real economic growth during the remainder of this year.

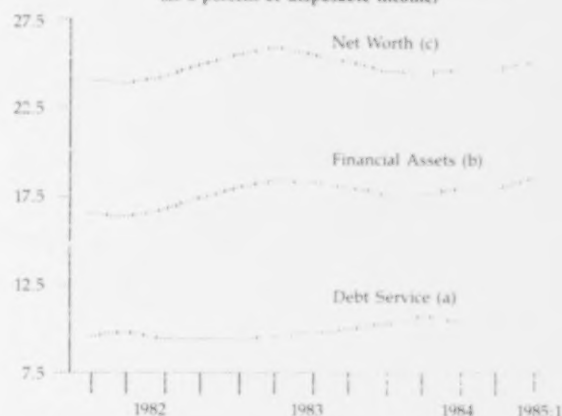
Rising Confidence Buoy Consumer Spending

While consumer demand was the strongest contributor to an otherwise lackluster first quarter, there remain concerns regarding the future strength of this sector. Although growth in spending for consumer durables (the most volatile component of consumer spending), and nondurables is greater than any peak since the 1960s, growth in some consumption categories has begun to falter. In particular, growth in spending for furniture, other consumer durables, food, clothing, and fuel, which rose faster than average during the first year of recovery, are no longer doing so. Further, in February, consumer spending outpaced income growth for the fourth consecutive month. This imbalance between spending and income, which leads to greater consumer indebtedness, could not be sustained for long, and indeed, it may have already run its course. In March, consumer spending fell by 0.5 percent, the result of a 1.2 percent drop in spending on goods and a sharp drop in expenditures for household operation. Also, while the debt-to-income ratio has remained stable, at approximately 17.5 percent, for three consecutive months, and is below the previous peak of 17.8 percent, it is high by historical standards and may limit future spending growth.

Nevertheless, we believe that the strength of consumer spending is far from over. After ten quarters of recovery, overall consumer spending has increased 1.6 percentage points faster than the average for the past five postwar recoveries. Although March consumption fell, part of that decline was due to a circumstance that is independent of consumers' attitudes and buying intentions, namely, a falloff in spending for household services, including electricity and utilities. This category of expenditures is largely shaped by weather patterns rather than consumer choice.

Other indicators of future consumption activity point to a relatively optimistic outlook. While, as we noted, household debt as a percentage of income is high, the willingness of consumers to acquire debt reflects households' confidence in the future of the economy. Further, the strength of household balance sheets could offset pressures stemming from the high debt burden. Chart 2 shows that interest payments on household debt as a percent of disposable income have remained stable for the past three years. Moreover, it shows that both the net worth and the financial assets of households are strong and rising. Real household financial assets rose by 8.6 percent in 1983 and 6.2 percent in 1984, and are projected to increase by 8.6 percent this year.

CHART 2
MEASURES OF HOUSEHOLD DEBT AND WEALTH
(as a percent of disposable income)



(a) Household ratio of interest payments on debt to disposable income (flow of funds data).

(b) Household financial assets outstanding as a percent of disposable income (flow of funds data).

(c) Household net worth (net of depreciation) as a percent of disposable income (flow of funds data).

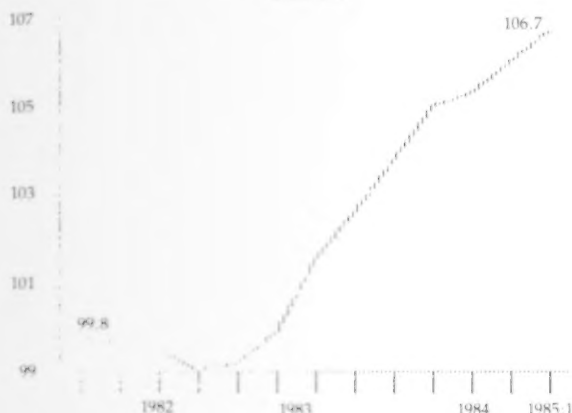
Personal income also continues to grow. Since September 1984, the monthly increase in personal income has averaged 0.5 percent and fluctuated only slightly about that average. Reflecting the strength of employment growth, the largest increase in March personal income was in the wages and salaries category. Although March after-tax income fell by 0.5 percent, this outcome is considered a fluke caused by the delay in mailing out income tax refund checks. Had tax refunds been on schedule, disposable income would have increased by 0.3 percent in February and 0.4 percent in March. While the unemployment rate remained at 7.3 percent in April, employment gains have been strong. American private industries have created more than one million new jobs since December 1984 (see Chart 3).

Interest rates are another important determinant of consumption, particularly for spending on big ticket items such as automobiles and furniture (which are typically bought on credit), as well as attitudes regarding the

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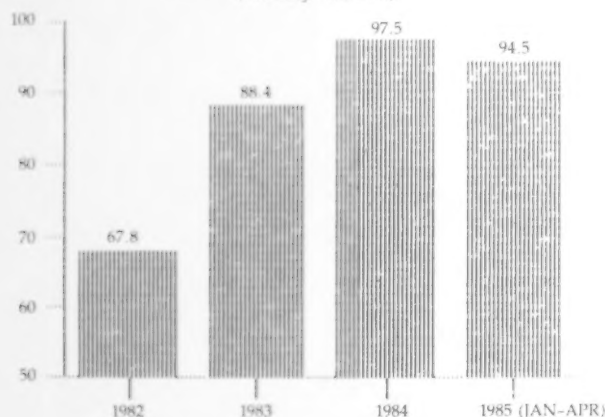
economy's future. Again, the latest data are encouraging. The three month Treasury bill rate, which was 8.94 percent on March 1st., fell to 7.98 percent by May 3rd. Similarly, other short-term interest rates declined: the 90-day commercial paper rate fell from 9.2 percent to 8.43 percent during the same period, while the federal funds rate fell from 8.74 percent to 8.19 percent. Long-term interest rates also fell, although not by as much. Thirty year Treasury bond rates fell from 11.82 percent to 11.3 percent. The prime rate remains at 10.5 percent but is expected to fall soon.

CHART 3
CIVILIAN HOUSEHOLD EMPLOYMENT
(millions)



Finally, consumer attitudes and buying intentions remain fairly strong. The recent decline in interest rates has already resulted in a change for the better in this important determinant of consumer spending. The index of consumer confidence rose to 94.6 in April from 93.7 in March (see Chart 4). Nowhere is the upbeat attitude of consumers as evident as in domestic automobile sales.

CHART 4
CONSUMER SENTIMENT INDEX (a)
(February 1966 = 100)



(a) Not seasonally adjusted.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Sales of new domestic automobiles reached 9.9 million units in the second ten selling days of April, and averaged 8.7 million units for the month as a whole, the highest selling rate for any month since 1979. While, the spurt in domestic car sales may have been influenced by the pending termination of subsidized financing programs, sales of models not included in these programs have also been strong, suggesting that underlying demand may be rising. Further, there is some evidence of a shift away from imports to domestic automobiles. Sales of new imported automobiles averaged 2.4 million units in 1984, bringing the import share of total car sales down to 23.6 percent from 26 percent in 1983. This trend continued in early 1985, with the import share falling further, to 21.7 percent, in the first quarter. However, a dark cloud on the horizon for domestic car sales lies in the forthcoming increase in imports of Japanese cars. Industry calculations place the increase in foreign penetration in the automobile market at 300,000 units this year, and an additional 400,000 units in 1986. The resulting increase in competition will benefit consumers as it is likely to result in downward price pressures.

The outlook for consumer purchases, including auto sales, remains relatively strong as falling interest rates, continued moderate increases in real disposable income and employment buoy consumer attitudes. This month's forecast anticipates increases in inflation-adjusted consumer spending of 3.9 percent in 1985 and 3.8 percent in 1986. Sales of new cars, domestic and imported, are anticipated to reach the eleven million unit level by the end of this year, compared to 10.5 million in 1984 and 9.2 million in 1983.

Housing Boom Continues

Residential investment has been one of the most vibrant sectors of the U.S. economy since the recovery began at the end of 1982. Since then, it has risen by 60.6 percent, two and a half times faster than average and almost five times faster than the increase in real GNP. First quarter housing starts averaged almost 1.8 million units, significantly above the 1.6 million unit average for the last quarter of 1984 (see Chart 5). March starts rose by 16.2 percent to 1.895 million units, largely due to a pick up in multi-unit structures; however, single family home starts continued on the upward trend begun last September. New single family home sales jumped by 8.9 percent in March, reaching their highest level since February 1984.

The March rise in starts may reflect erroneous perceptions that mortgage interest rates have bottomed out, since the March consumer sentiment survey showed a substantial rise in the proportion of respondents expecting interest rate increases in coming months. In fact, however, mortgage rates fell from the six-quarter peak of 14.11 percent reached in the third quarter of last year, to 12.73 percent in the first quarter of 1985 (see Chart 6), and are expected to fall to 12 percent by the end of this year.

The housing affordability index, a measure of households' ability to meet the income requirements to qualify for a mortgage loan, has risen of late and is expected to continue doing so. This means that the number of qualifying households has increased. A one percentage point decline in mortgage interest rates increases the number of households able to qualify for a mortgage loan by 400,000 to 500,000; seventy-five percent of which translates into home sales. This suggests that the continued slide in mortgage interest rates that we expect during the remainder of this year, will raise home sales by 350,000 units.

CHART 5
TOTAL NEW HOUSING STARTS
(millions)

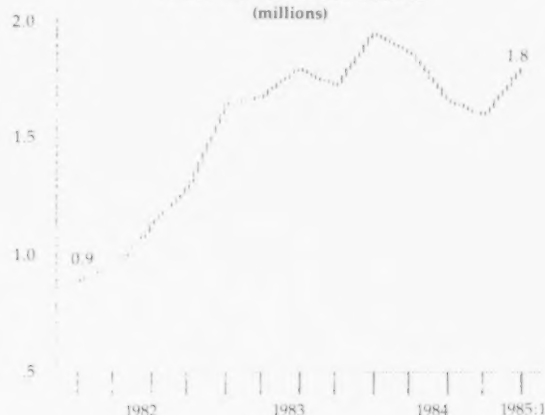
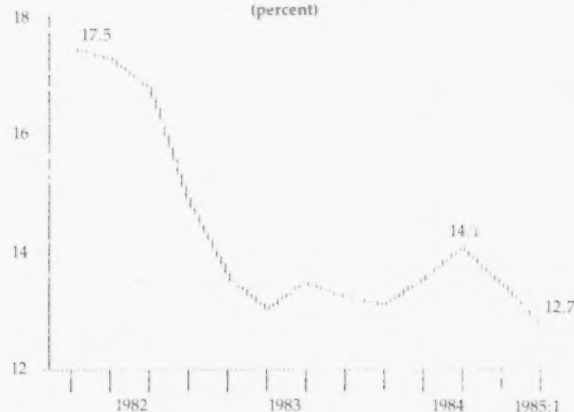


CHART 6
MORTGAGE INTEREST RATE (a)
(percent)



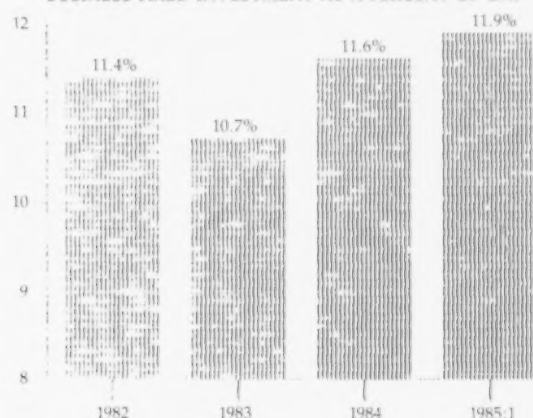
(a) Effective conventional commitment mortgage rate, combined lenders, 25-year, 75 percent loan.

Total building permits for March rose a strong 11 percent to 1.8 million, the highest level of permits in the past 12 months. Since permits lead starts by about six months, this indicates that we can look forward to a summer of continued strength in the housing sector. We anticipate that housing activity will remain strong throughout the forecast interval. New starts are expected to average 1.9 million units by the end of this year.

Business Fixed Investment: Still the Leader

Business fixed investment has also been a mainstay of the economy's growth. In the past ten quarters, it rose by 31.5 percent, almost twice as fast as the recovery average and two and a half times faster than real GNP. There are indications, however, that this sector is settling down. Investment gains in the first half of 1984 were 21 percent, but only 8.5 percent in the fourth quarter. Preliminary estimates for the first quarter of this year place the increase in nonresidential investment at only 3.2 percent. However, the ratio of nonresidential investment to GNP reached 11.6 percent in 1984 compared to a low of 10.4 percent in the second quarter of 1983. It continued rising during the first quarter of this year, reaching an eleven-quarter peak of 11.94 percent (see Chart 7), and is expected to reach 13.1 percent by the end of 1986.

CHART 7
BUSINESS FIXED INVESTMENT AS A PERCENT OF GNP



Several developments, in particular, the decline in interest rates of the past two months, buoy this sector. The expected continuation of the downward trend in interest rates will further reduce the cost of capital and enhance investment. Despite the inroads that imports continue to make in domestic markets, domestic demand remains strong (see Chart 1 above).

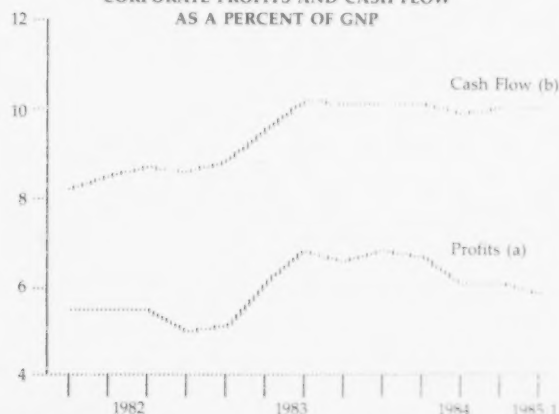
Nevertheless, the impact of import penetration should not be underestimated. While growth in equipment investment has been extraordinarily strong, historical comparisons show that growth in the production of business equipment parallels investment gains. This time around, however, output of final business equipment has risen by 23.1 percent, compared to 16.7 percent for the average of the past four recessions; while investment has risen by 40.7 percent compared to an average increase of 18.2 percent. The gap between production and investment is evidence of import penetration. Industrial production rose by 0.3 percent in March, recovering from the February decline, but output is still 0.4 percent below last summer's peak.

Slowing sales, plus the need to contain inventories can lead to a slowdown in industrial production growth and a decline in the rate of capacity utilization, reducing corporate profits and cash flow. Inventory accumulation, which has gone on steadily for almost two years, increased by 0.4 percent in both January and February. However, the rate of growth has slowed since October. Part of the increase was intentional and can be discounted, as it primarily reflected the restocking of automobiles, which accounts for half of the January increase in inventories. Defense orders also played a significant role in the recent inventory build up because of the long production lags and cost plus nature of the sector. Defense orders have grown one and a half times faster than total manufacturing orders since 1978 and now account for 37 percent of unfilled orders. Some unwanted accumulation occurred in the nondefense capital goods sector.

An inventory correction is probably taking place now, although its magnitude should not be worrisome. In keeping with recent experience, business accumulation of inventories will remain cautious. Businesses seem determined to minimize the inventory-to-sales ratio and the past damage to profits induced by inventory cycles has reinforced this strategy.

Both profits and cash flow remain relatively strong (see Chart 8). Before tax corporate profits stand at about six percent of GNP and are anticipated to remain within that range throughout the next two years. Net cash flow reached ten percent of GNP in 1984, compared to 9.6 percent in 1983 and 8.5 percent in 1982. During the fourth quarter of 1984, profits increased at an annual rate of 16 percent, buoyed by very large gains in the profits of non-financial corporations. In that same quarter, the financing gap—the difference between capital expenditures and corporate cash flow, with book value depreciation

CHART 8
CORPORATE PROFITS AND CASH FLOW
AS A PERCENT OF GNP



(a) Before tax corporate profits as a percent of gross national product.

(b) After-tax corporate profits plus book value capital consumption allowance minus dividends, as a percent of gross national product.

allowances—was zero, implying that nonfinancial corporations, on average, were able to finance all of their capital investment out of internal funds. Profits from current production have been robust for two years. After-tax profits, on the other hand, have done poorly, but this largely reflects accounting changes. The impact of accelerated depreciation reduces taxable profits but adds significantly to cash flow.

There is some evidence of a future slowdown in fixed investment, stemming largely from nonresidential building. Investment in nonresidential structures is expected to weaken in the next few quarters because office and commercial building, the mainstay of nonresidential building, is faced with very high vacancy rates in some locations. Nevertheless, several long-term incentives to nonresidential investment remain strong. Particularly important is the capital replacement need that this country faces. The nation's net effective capital stock in 1985 should be slightly higher than in 1979, but still below the level of the 1960s. To remain competitive, and in fact, increase their international competitive position in order to adequately defend themselves from imports, American industries will need to sustain a high level of investment to boost productivity and improve quality. Finally, as a further spur to capital investment, the relative cost structure of production continues to point to the substitution of capital for labor.

Other indications of the relative strength of future investment involve recent evidence on shipments and new orders of durable goods. After eight months of erratic movements, new orders for nondefense capital goods rebounded sharply (29.6 percent) in February, reaching a new peak and, in part, contributing to a 5.4 percent increase in March shipments. Although new orders for nondefense capital goods declined in March, new orders for defense capital goods and household durables rose by 24 percent and three percent, respectively.

Net Exports: Still the Sour Note, but Slowly Improving

The U.S. current account has swung from a surplus in the spring of 1982 to a deficit of \$102 billion in 1984. During the past ten quarters, real imports have risen by 41 percent, almost twice as fast as the average recovery experience, while real exports have actually declined by 1.8 percent, compared to an average recovery increase of 21 percent. The March merchandise trade deficit held steady at \$11 billion. In spite of the recent month-to-month swings in exports and imports, the merchandise trade deficit has remained in the neighborhood of \$11 billion a month over the past year.

The factors contributing to the continuing rise in our balance of payments deficit have been discussed often in these pages. They include: the high value of the dollar,

which makes foreign goods relatively less expensive than American goods; differences in recovery cycles between the U.S. and its major trading partners, which have constrained the foreign demand for U.S. goods; the debt crisis faced by the developing nations, which has resulted in a sharp cutback of imports by these nations as they attempt to increase their foreign exchange earnings to service their massive foreign debt; and the problems faced by the OPEC nations, i.e. the softness in world oil prices has resulted in a shortfall in revenues for this group of countries, restricting their ability to purchase foreign goods. (See *Delusive Trade Deficit*, ECONOMIC OUTLOOK, August/September 1984, and *The Mystery of the Dollar*, ECONOMIC OUTLOOK, April 1985).

We have consistently expressed our view that the dollar's strength derives from significant structural changes in the U.S. economy. Recent data from the Federal Reserve Bank of St. Louis adds strength to this viewpoint. In order to evaluate the significance of the dollar's strength, their report distinguishes between real and nominal exchange rate changes. A nominal exchange rate change balances differences in inflation between the U.S. and its trading partners. Changes in the real, or inflation-adjusted exchange rate, on the other hand, reflect changes in purchasing power resulting from structural changes such as relative price shifts, changes in tax laws or altered expectations about the future yield of assets. The data on the trade-weighted value of the dollar show a persistent exchange rate movement which more than offsets inflation differentials. The study concludes that the strength of the dollar follows from changes in the tax laws which have improved long-term prospects for the U.S. economy.

A comparison of bilateral trade between the U.S. and its major trading partners shows no clear pattern pointing to the acceleration in the value of the dollar as the real culprit. Since 1980, when the dollar began to appreciate, U.S. exports to the United Kingdom fell by four percent, to France and Italy by 20 percent, and to West Germany, by 17.3 percent. However, the decline in the value of their currencies with respect to the dollar bears no clear relationship. The pound sterling fell by 43 percent *vis-a-vis* the dollar between 1980 and 1984; the French franc and the Italian lira fell by 52 percent and 51 percent, respectively; and the German mark fell by 36.1 percent. During this same period, although the Canadian dollar fell by almost ten percent against the U.S. dollar, U.S. exports to Canada actually rose by 31 percent. Similarly, while the yen lost five percent of its value to the dollar, U.S. exports to Japan rose by almost 14 percent (see Table 1). France, Italy, and the United Kingdom, three countries with low-valued currencies, had trade deficits of \$2.1 billion, \$11.4 billion, and \$6.3 billion, respectively, during the past twelve months.

American industry has become increasingly less com-

petitive in world markets. Regardless of the measure used, whether relative costs, market shares, or productivity levels, the U.S. is still far less competitive today than at any time in the postwar period. The U.S. share of the global market has declined from 28 percent of adjusted total exports by major industrial countries in 1960, to 20 percent in 1972, remaining close to 20 percent since then. For purposes of comparison, the U.S. market share is now close to parity with that of West Germany, whose gross national product is approximately one-quarter the size of the U.S. The European Economic Community has also lost market shares—its percentage of total global exports fell from 48 percent in 1960 to 38 percent in 1983. Japan, not surprisingly, has emerged as the clear winner in the scramble for world markets, its share rose from five percent in 1960 to 13 percent in 1983.

TABLE 1
BILATERAL TRADE AND EXCHANGE RATES
(1980 to 1984)

U.S. Trade with:	Percent Change in Exports	Percent Change in Imports	Percent Change in Exchange Rate
United Kingdom	-3.9	+45.6	-42.6
France	-20.0	+51.8	-51.5
West Germany	-17.3	+44.7	-36.1
Italy	-20.0	+80.9	-51.3
Canada	+31.4	+59.3	-9.7
Japan	+13.5	+83.0	-5.0

One reason for this outcome is the decade-long slowdown in the rate of growth of U.S. labor productivity, which only recently began to reverse. Although the average productivity of American workers is still higher than that of workers in our major trading partners, and it has continued to rise, productivity in the rest of the world has nearly caught up by growing much more rapidly. Labor productivity in Japan has risen from 27 percent of U.S. productivity in 1960, to 72 percent in 1981; while the productivity of the European nations rose from 53 percent to 80 percent over the same period (see *The Productivity Challenge*, ECONOMIC OUTLOOK, April 1985). Relative costs of production also play an important role. Compared to Japan, the U.S. real after-tax cost of funds has typically been substantially higher. In 1984, Japan's total manufacturing costs were only 71 percent of those in the U.S.

This month's outlook shows an improvement in real exports as the dollar loses some of its strength and the recovery abroad continues. The trade-weighted exchange value of the dollar rises by 4.8 percent in 1985, compared to its average level in 1984, and then falls by 6.6 percent in 1986. However, the improvement in exports due to declines in the value of the dollar will not occur immediately since only about forty percent of the dollar's decline is reflected in contemporaneous improvements in exports. Industrial production in Japan, Canada, and

Europe is expected to continue strengthening, rising by 8.1 percent, 5.3 percent, and 4.4 percent, respectively, in 1986. This combination of a declining dollar and stronger growth abroad should raise the demand for U.S. goods and services, contributing to an 8.9 percent increase in real exports in 1986. The rise in real imports, on the other hand, should decelerate from 27 percent in 1984, to 6.2 percent in 1985 and 6.1 percent in 1986. The U.S. real trade balance on goods and services, which registered a surplus of \$12.6 billion in 1983 and a deficit of \$15 billion in 1984, deteriorates further to \$24 billion in 1985, but improves to a deficit of \$21.4 billion by 1986.

Prices, Wages and Productivity: No Inflationary Threat on the Horizon

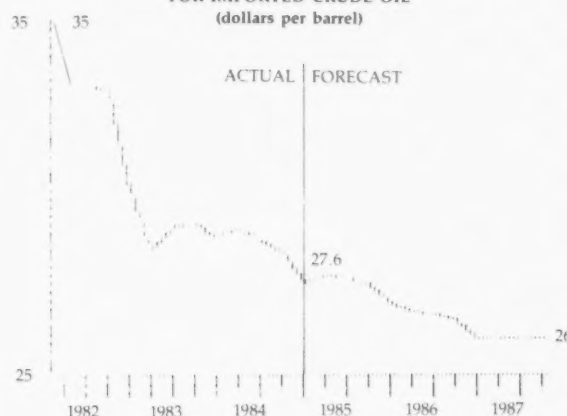
Although recent declines in the value of the dollar, higher commodity prices, and the 5.3 percent increase in the implicit GNP deflator for the first quarter point to a slight worsening in inflation, there is little reason to worry about another price spiral. While a decline in the dollar's value will translate rather promptly into increased prices, as of early May the effective weighted-average exchange rate was still 11.9 percent above its year-ago level. Nevertheless, the rise in consumer prices in March, because it resulted from two categories of consumption which have a large import component, suggests that the slide in the value of the dollar may have begun to be felt in domestic price increases.

The recent drop in the value of the dollar led to a modest recovery in commodity prices, but only when compared to previously depressed levels. The *Journal of Commerce* spot commodity price index rose 1.4 percent in the four weeks ending March 29, with metals prices leading the way, however, they remain 8.4 percent below their year-ago level. Lumber prices, on the other hand, collapsed—the victim of excess capacity, a problem which continues to plague the industry.

After months of weakness, world oil prices began firming in February and March due to several factors. Among these are: (1) OPEC's apparently improved ability to control its own production levels; (2) extreme winter temperatures in Europe, which increased demand; and (3) large inventory requirements—end of year stocks in the OECD nations were at their lowest level in five years. Nevertheless, a continued erosion in the demand for oil, to the benefit of other fuels, has become increasingly apparent. World oil consumption grew by only one percent in 1984 despite the five percent surge in economic activity in the industrialized nations. While the short run outlook is for stability in crude oil prices, some factors argue for a price reduction in the longer term (see Chart 9). Significant among these is increased competition in world oil markets, both in production and refining of crude petroleum. Further, a substantial decline in the value of the dollar increases the likelihood of a dramatic break in prices.

Because Middle-Eastern producers rely largely on the European nations as a source of imported goods, a fall in the value of the dollar would reduce their purchasing power, making it necessary for them to increase their exports, and hence, their production of crude, in order to earn the additional foreign exchange with which to pay for imports. This increase in production would raise the available supply, placing downward pressure on prices.

CHART 9
AVERAGE REFINERS' ACQUISITION PRICE
FOR IMPORTED CRUDE OIL
(dollars per barrel)



The sharp rise in the first quarter's GNP deflators should be discounted because it reflects changes in the mix of GNP and federal pay increases. A surge in the consumption of energy early in the quarter accounts for the discrepancy between the implicit and fixed-weight deflators. Since 1972, energy price deflators have increased more than others. Therefore, a shift towards high-priced energy purchases would lead to an increase in the value of the implicit deflator. The increase in the fixed-weight deflator, on the other hand, was entirely due to the federal pay increase. If this sharp rise in the GNP deflators is an indication of sustained inflationary pressures, we would expect to see corresponding increases in producer and consumer prices. However, while consumer prices rose in March, the rise did not reflect an across-the-board acceleration. Excluding the increase in energy prices, the consumer price index rose by only 0.3 percent. Producer prices rose by 0.2 percent, following a 0.1 percent decline in February. This trend continues the up/down pattern which has kept producer prices in a plateau for the last year.

On the wage front, several factors argue for continued moderate increases in wages. Private sector compensation rose by 4.4 percent in March compared to its year-ago level, the smallest increase since 1979. Included among the factors which will restrain the growth in wages are an increase in competition from three sources: (1) nonunion competition has intensified; (2) deregulation of certain key industries has increased competition in domestic labor markets; and (3) foreign competition continues strong. Also, in spite of a dramatically improved employment

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1986
 Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally
 adjusted annual rates unless otherwise noted.

	QUARTERS									YEARS		
	Actual		Forecast							Actual	Forecast	
	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	4.3	1.3	4.5	4.4	3.9	4.7	4.2	4.4	4.5	6.8	3.5	4.3
Consumption	3.6	4.7	4.0	3.6	3.9	4.1	3.4	3.4	3.6	5.3	3.9	3.8
Residential Investment	-5.9	-0.7	7.2	19.1	2.1	4.6	8.2	8.9	9.9	12.2	1.9	7.5
Business Fixed Investment	8.5	3.4	9.0	7.8	10.3	12.0	12.4	11.2	12.5	19.8	8.7	11.0
Equipment	5.4	-1.2	8.8	9.1	12.0	14.1	14.5	13.6	13.7	21.5	7.6	12.8
Structures	17.2	16.2	9.4	4.7	6.0	6.8	7.1	5.1	9.3	15.6	11.4	6.5
Exports	-0.8	-8.2	4.6	5.1	10.5	10.1	9.3	9.6	9.4	4.7	0.7	8.9
Imports	-28.3	26.2	-3.2	6.2	7.1	8.0	6.5	4.8	6.6	27.0	6.2	6.1
Government Purchases	5.9	0.1	4.7	3.0	-3.6	0.5	0.3	0.6	1.0	3.5	3.9	0.3
Inventory Change (\$B)	37	47	39	38	42	43	42	42	40	58	41	42
New Car Sales (mil. units)	10.3	10.8	10.8	10.9	11.1	11.2	11.3	11.6	11.8	10.4	10.9	11.5
Housing Starts (mil. units)	1.6	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.1	1.8	1.8	2.0
EMPLOYMENT, WAGES AND PRICES												
Unemployment Rate (%)	7.2	7.3	7.2	7.1	7.0	6.9	6.7	6.6	6.5	7.5	7.2	6.7
Compensation	3.6	10.4	3.9	4.4	4.7	6.3	5.4	5.7	5.9	4.2	5.6	5.6
Productivity	2.3	-1.5	2.6	2.3	2.9	2.5	2.4	2.6	2.8	2.7	1.4	2.6
Unit Labor Costs	1.3	7.5	1.3	2.1	1.8	3.7	3.0	3.0	3.2	1.4	4.2	3.0
Consumer Prices	3.5	3.3	3.6	3.4	3.6	3.8	3.8	3.8	4.0	4.3	3.5	3.7
GNP Deflator	2.8	5.3	2.9	2.6	3.3	3.5	3.6	3.8	4.3	3.8	3.6	3.4
Prime Interest Rate (%)	11.8	10.5	10.3	10.0	9.8	9.3	9.1	8.6	8.4	12.0	10.2	8.8
Profits from Current Production (\$B)* ..	203.9	209.8	220.8	225.2	230.0	233.2	239.8	244.6	247.6	195.9	221.5	241.3
GOVERNMENT FISCAL POLICY (\$BILLION)**												
Unified Budget—Receipts										666	740	794
Unified Budget—Outlays										842	954	972
Unified Budget—Federal Surplus or Deficit										-176	-214	-178

*Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

SOURCE: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's first estimates of the National Income and Product Accounts for the first quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government spending of \$40 billion in fiscal 1986. Government spending, on an NIA basis, grows at an average annual rate of three percent between 1985 and 1987. The nation's money supply, as measured by M(1), is anticipated to grow by 6.6 percent in 1985 and 6.4 percent in 1986. The federal minimum wage remains at \$3.35 an hour throughout the forecast interval. Due to inventory requirements, the average price of imported crude oil strengthens slightly in the near term; it remains at \$27.70 in 1985, but falls to \$26.79 in 1986. The trade-weighted exchange value of the dollar rises by 4.8 percent in 1985 compared to the average 1984 rate, but depreciates by 6.6 percent in 1986.

situation due to the economy's continued ability to create new jobs, the civilian unemployment rate remains high as the labor force continues to swell. This will also maintain downward pressure on increases in wages.

Nonfarm business sector productivity decreased at an annual rate of 1.5 percent in the first quarter. However, output per hour in the manufacturing sector rose by 1.7 percent on the strength of a 3.1 percent advance in productivity in the durable goods sector. First quarter unit labor costs rose by 7.5 percent in the nonfarm business sector as increases in compensation outstripped productivity gains. However, the 10.4 percent surge in employee compensation was associated with the January 1st increase in employer contributions to Social Security. For an in-depth discussion of the productivity issue, see last month's ECONOMIC OUTLOOK.

Federal Budget

This month's outlook assumes that efforts to reduce federal spending meet with only partial success. The static reduction in federal outlays amounts to \$40 billion in 1986 compared to \$52 billion in the White House/Republican Leadership compromise budget plan. Real economic growth is anticipated to remain relatively strong, rising by 3.5 percent in 1985, and 4.3 percent in 1986. This leads to a real increase in investment for producers' durable equipment of 22.4 percent by the end of 1986 compared to the actual (first quarter) level. Rising levels of investment spur growth in labor productivity, which is expected to rise by 2.6 percent in 1986. As a result, the civilian unemployment rate falls to 6.7 percent in 1986 as 4.4 million new civilian jobs are created. Inflationary pressures remain moderate, the consumer price index rises by 3.5 percent in 1985 and 3.7 percent in 1986, compared to 4.3 percent in 1984. The prime interest rate trends down, averaging 10.2 percent in 1985 and 8.8 percent in 1986. The unified federal deficit reaches \$214 billion in fiscal year 1985, but falls to \$178 billion in fiscal year 1986.

Conclusion

In closing, we would like to remind the reader that a forecast is only as good as the data on which it is based. In this regard, recent analyses have called into question the reliability of official data as accurate measures of economic activity. Problems exist with the calculation of two measures of prices which feed into the real GNP data. Experts in business cycle research have noted that the treatment of the implicit deflator for imports causes an understatement of real GNP, which amounted to as much as one percentage point during each of the past several quarters. Moreover, a recent report by the Council of Economic Advisers (CEA) points to serious measurement errors in real GNP, which arise out of the way in which the government calculates the price of computers in assessing their contribution to total production.

Currently, these calculations are made under the assumption that the price of computers remained unchanged over the years, and that any increases in prices were matched by the cost of quality improvements, thereby yielding no change in real costs. However, this assumption has not held true. Since the late 1970s, manufacturers have consistently introduced new computer models which were both lower priced and of a substantially improved quality. While this was not a major issue in 1975 when computers were a very small proportion of overall production, their importance has since risen significantly. Purchases of computing equipment reached \$17 billion in 1982, the equivalent of eight percent of purchases of producers' durable equipment. A measure of the importance of this erroneous assumption is contained in the CEA report, which states that in each of the last three years, reported real GNP growth would have been more than one percentage point higher had computers been properly taken into account. Unfortunately, the problems do not stop at measured GNP. This error also raises questions regarding the reliability of other indicators of economic health. The error in the reporting of GNP feeds through to other statistics, such as productivity, the producer price index, industrial production and retail sales.

THE ECONOMIC IMPACT OF THE WHITE HOUSE/REPUBLICAN LEADERSHIP COMPROMISE BUDGET PACKAGE

by

Graciela Testa-Ortiz

While we expect that the economy will continue on a path of relatively stable, noninflationary growth, this forecast could partially depend upon the outcome of budget deliberations now taking place in the Congress. Budgetary deadlock, followed by a tax increase as an attempt to cover the deficit, could lead to a very dismal outlook for the nation's economy.

Data Resources, Inc. (DRI) has recently developed several simulations of how the economy might fare under different fiscal outcomes. Under one such scenario, the recent declines in interest rates, coupled with the rise in consumer confidence which has also become evident, contribute to strong economic growth during the remainder of this year. However, as we near 1986, according to DRI, Congress' failure to enact a new budget which effectively addresses the problem of soaring federal spending growth, significantly reduces business and consumer confidence. At the same time, strong growth in 1985 increases credit demands, which because they are not satisfied through monetary ease, result in rising interest rates, pushing the economy into recession by the second quarter of 1986.

In this DRI scenario, the recession lasts through the end of 1986, with real GNP falling by 1.7 percent from the economy's peak in the first quarter of 1986, to its trough in the last quarter of 1986. Total automobile sales (domestic and imports) fall to a low of 9.1 million units, although total consumption drops modestly. Nonresidential investment declines by 7.5 percent, and new housing starts drop by 516,000 units as mortgage interest rates reach 14.24 percent in 1986. Total nonfarm employment falls by 1.39 million jobs, and the civilian unemployment rate reaches a peak of 8.95 percent. Towards the end of 1986, looser monetary policy and lower interest rates contribute to a recovery beginning in 1987.

DRI has also performed an econometric simulation of the impact of the White House/Republican Leadership compromise budget plan, which includes the spending reductions called for in that package. In addition, in keeping with Federal Reserve Board Chairman Paul Volcker's statements that monetary policy can only be eased once something is done about the federal deficit, this simulation assumes that he keeps his word. The nation's money supply, as measured by M(1), grows by 6.4 percent in 1986 and 5.9 percent in 1987, compared to 5.4 percent and 5.7 percent, respectively, in the recession scenario.

A comparison of these two scenarios makes a dramatic case in support of the compromise budget plan (see Table 1). According to DRI, enactment of the budget plan would result in the following:

- Real gross national product rises by \$13.4 billion in 1986 and \$59.4 billion in 1987.
- Real consumer spending increases by \$3.2 billion in 1986 and \$20.8 billion in 1987.
- Real nonresidential investment rises by \$1.2 billion in 1986 and \$30.4 billion in 1987. A large part of the increase in nonresidential investment is in productivity-enhancing producers' durable equipment, which rises by \$0.7 billion in 1986 and \$21.6 billion in 1987. Investment in nonresidential structures rises by \$0.5 billion and \$8.8 billion, respectively.
- Real residential investment also benefits, rising by \$8.2 billion in 1986 and \$10.1 billion in 1987. New housing starts increase by 415,000 units in 1986 and 195,000 units in 1987.
- Real exports of goods and services rise by \$0.9 billion in 1986 and \$7.5 billion in 1987, while real imports of goods and services decline by \$1 billion in 1986, but rise by \$5.3 billion in 1987. This results in an improvement in real net exports of goods and services of \$1.9 billion in 1986 and \$2.2 billion in 1987. By the end of 1987, the U.S. dollar has fallen in value by 20 percent relative to its current level.

TABLE 1
ECONOMIC IMPACT OF THE COMPROMISE
BUDGET PLAN
(difference from recession scenario in billions of
1972 dollars, unless otherwise indicated.)

	1986	1987
Gross National Product (a)		
Real GNP	\$13.4	\$59.4
Consumer Spending	\$3.2	\$20.8
Nonresidential Investment	\$1.2	\$30.4
Equipment	\$0.7	\$21.6
Structures	\$0.5	\$8.8
Residential Investment	\$8.2	\$10.1
Housing Starts (b)	415,000	195,000
Exports	\$0.9	\$7.5
Imports	(\$1.0)	\$5.3
Real Net Exports of Goods and Services	\$1.9	2.2
Federal Government Purchases	(\$5.2)	(\$11.3)
EMPLOYMENT, WAGES AND PRODUCTIVITY (c)		
Nonfarm Employment (d)	90,000	314,000
Unemployment Rate (e)	-0.15	-1.3
Consumer Price Index	-0.7	0.0
Implicit GNP Deflator	-1.0	-0.5
Average Hourly Earnings	-1.1	0.4
Compensation	-0.9	0.6
Labor Productivity	0.2	0.8
Unit Labor Costs	-1.1	-0.3
INTEREST RATES (f) AND THE DEFICIT (g)		
Prime Rate	-437	-224
Federal Funds Rate	-497	-258
3-month Treasury bill Rate	-441	-234
AAA Corporate Bond Rate	-165	-239
Mortgage Rate (h)	-186	-219
Unified Receipts	-8.6	18.0
Unified Outlays	-74.8	-138.8
Unified Deficit	-66.2	-156.8
(a) Parentheses indicate negative values.		
(b) Increase in housing starts relative to recession scenario.		
(c) Percentage point difference in growth rates relative to recession scenario, unless otherwise indicated.		
(d) Increase in number of jobs relative to recession scenario.		
(e) Percentage point difference in unemployment rate relative to recession scenario.		
(f) Basis points difference relative to recession scenario.		
(g) Difference relative to recession scenario in billions of current dollars.		
(h) 25 year mortgage, 75 percent loan.		
Source: Data Resources, Inc. The recession alternative is LATERECESS0585. The simulation of the White House/Republican Leadership compromise budget plan is NEWBGTACC0585.		

- Nonfarm employment increases by 90,000 in 1986 and 314,000 in 1987, and the civilian unemployment rate falls by 0.15 percentage points in 1986 and 1.3 percentage points in 1987.
- Measures of prices, wages and productivity improve as a result of the enactment of the budget compromise plan. Growth in the consumer price index falls by 0.7 percentage points in 1986, while the rate of increase in the implicit GNP deflator declines by one percentage point in 1986 and 0.5 percentage points in 1987. The rate of growth in average hourly earnings falls by 1.1 percentage points in 1986, but rises by 0.4 percentage points in 1987. Growth in labor productivity rises by 0.2 percentage points in 1986 and 0.8 percentage points in 1987. Consequently, growth in unit labor costs decelerates by 1.1 percentage points in 1986 and 0.3 percentage points in 1987.
- These improvements in the nation's economy come about, in large part, as a result of substantial declines in interest rates as federal credit demands ease. The prime interest rate falls by 437 basis points in 1986 and 224 basis points in 1987. The decline in other interest rates is detailed in Table 1.
- The compromise budget package leads to large declines in the unified federal budget deficit. On a calendar year basis, the unified deficit falls by \$66.2 billion in 1986 and \$156.8 billion in 1987, largely as a result of declines in federal outlays which fall by \$74.8 billion in 1986 and \$138.8 billion in 1987 (these are dynamic, not static, changes in outlays). If the budget plan is enacted, the NIA deficit falls to 3.1 percent of GNP by 1987, compared to 6.7 percent under the recession scenario.
- In terms of government share of GNP, the enactment of the compromise budget plan would reduce government outlays to 22.7 percent by 1987. In contrast, under the recession scenario, government spending as a percent of GNP would continue rising, from 24.4 percent in 1985 to 26.2 percent by 1987.
- The compromise budget plan shifts the composition of real GNP away from consumption, which falls from 65.3 percent of GNP in 1985 to 65 percent by 1987, compared to an increase in this ratio to 66 percent under the recession scenario. Nonresidential investment rises to almost 14 percent of GNP by 1987, compared to 13 percent in 1985. Under the recession alternative, nonresidential investment would only amount to 12.6 percent of GNP by 1987. The continued improvements in investment, which began in 1981 with the enactment of the Economic Recovery Tax Act, help to enhance the long-run potential of the U.S. economy by creating new jobs, improving the international competitiveness of U.S. firms, raising labor productivity, and ultimately, providing an improved standard of living for all Americans.

FEDERAL BUDGET FOLLIES

by
William Orzechowski

Nearly everyone agrees that federal spending is out of control, but few members of the public fully appreciate the many absurdities that arise when government spending programs encroach upon so much of the American economy. More often than not, average and below average income workers must pay heavy tax burdens to subsidize individuals who have incomes that greatly exceed their own. Moreover, these subsidies many times go for programs that should have never existed in the first place. In other cases, the federal budget is simply a device to shuffle money so that individuals in one location subsidize those in another location when, in fact, there is no rationale for any subsidy in the first place. What follows are some examples of these distortions.

Farm price support subsidies have to rank at the top in terms of fiscal perversity. The average hard working factory worker earns about \$17,500 a year. He will pay approximately \$3,300 in total taxes to the federal government, of which \$66 go to support \$15 billion of price support subsidies in 1985. Nearly 40 percent of this subsidy, or \$6 billion, goes to the largest ten percent of farms, translating into a subsidy of, at least, \$16,000 for each. Net income for this group averages a whopping \$84,000 per year. Further, the average equity position of the top 29 percent of all farms is about \$800,000. In essence, our hard working factory worker is paying \$66 so that farmers, with much greater assets and income, can receive a \$16,000 annual subsidy.

Unfortunately, this is not the end of the farm story. What does our average factory worker get for his \$66 contribution to farmers? He gets to pay higher food prices. For example, the federal price support program means that he has the privilege of paying more than double the world price for dairy products and over four times the world price for sugar.

Let's take the case of an average service worker in Philadelphia, who commutes to work each day on Philadelphia's subway system, which was built at the turn of the century. He will pay seven cents of his income in federal taxes this year so that residents of the Washington, D.C. metropolitan area can receive a \$250 million grant to finish building their new, posh subway system. In essence, the Philadelphia service worker, who earns \$11,000 a year, is making it possible for Washington's commuters to receive a \$200 per capita subsidy to finish their transit system. However, the average income of Washington commuters exceeds \$20,000 a year. Why should those who sit in Philadelphia's trolley cars pay seven cents of their income so that relatively affluent Washingtonians can ride in their sleek Metro?

One of the greatest distortions involves Social Security. This program pits today's workers against those who are retired and those approaching retirement. The average worker below age 44 pays about \$1,500 per year in Social Security taxes. This goes to the typical retiree who collects almost \$5,338 annually in Social Security benefits. Yet, the per capita income of an elderly household is greater than that of a non-elderly household (\$9,080 versus \$8,960). Furthermore, the typical retiree owns many more assets and pays less taxes than our young worker. However, the kicker is that the relatively affluent retiree is being subsidized at a phenomenal rate on his Social Security benefits. As unbelievable as it sounds, the typical retiree will receive real lifetime Social Security benefits of about \$95,000, but his payments and those of his employer, including the value of interest over the period, add up to a mere \$30,000. In effect, over his lifetime, the retiree will receive benefits which greatly exceed the value of his total contribution. In spite of all this, most Social Security recipients live under the illusion that they have *paid* for their benefits, and there are a host of politicians willing to perpetuate this notion.

Today's young workers will not fare so well. By the time they retire, simple demographics will force them to receive a much lower return on their rising payroll taxes.

In 1986, about \$8 billion in federally subsidized loans and grants will be granted to college students. Aid available from federal and state sources amounts to about \$1,000 per year for every college student in America. Unfortunately, a good portion of such aid goes to students whose parents' income substantially exceeds the national average, since 25 percent of all college freshmen receiving federal aid are from families in the upper half of the income distribution.

Let's take the case of a hard working factory worker who never went to college. Of the \$3,300 he pays in federal taxes per year, \$35 will go to support student loan programs. About \$5 of this will go to families with almost double his income. This will make it possible for the relatively rich family to receive a \$3,000 subsidy in the form of guaranteed student loans (GSL) for their children who attend college (\$3,000 is the subsidy value for four years of GSLs). After college these individuals will go on to receive a much higher income than our factory worker.

The Civil Service Retirement System is a classic federal boondoggle. Our average factory worker shells out \$105 of his \$3,300 in federal taxes to subsidize the pensions of highly paid federal workers which, on average, will be over double the average private sector pension. Federal employees pay only 20 percent of the cost of their retirement benefits; the taxpayer is stuck with the remaining 80 percent. An average federal retiree with a final salary of \$25,000 will receive about \$542,000 in lifetime benefits. A private sector worker with the same salary will get

about \$266,000 in lifetime benefits. A federal retiree with a final salary of \$50,000 will receive a lifetime benefit of \$1,085,000, compared to \$398,000 for his private sector counterpart. Even more galling is the fact that the private sector worker will be toiling at his job until he reaches his sixties, while the federal worker can retire as early as age 55.

The Rural Electrification Administration (REA) makes loans to rural electric co-ops at the bargain rate of five percent. Until 1973, it made those loans at two percent. Between 1973 and 1983, the value of below market loan subsidies to co-ops for the life of the loan is conservatively estimated at \$33 billion. The purpose of these loans is to make electricity available to rural America. However, the taxpayer would become electrified if he knew that 98 percent of rural America had already received electricity by 1954! Instead, this boondoggle program continues merely to make electricity rates lower, on average, by 12 percent for co-op customers, while the rest of us fork up tax dollars to keep the subsidies going. What do we get for this? A system bordering on default that led to a bill in Congress—S.1300—that would essentially forgive many of the subsidized loans owed by the REA to the U.S. Treasury.

The Amtrak gravy train has been rumbling along for many years. What the public does not know, however, is the monumental costs needed to keep the system going. Revenues cover only 58 percent of operating costs, and they do not even begin to cover fixed costs—depreciation, taxes, interest, and labor protection. System-wide, the average subsidy per passenger is \$35. On some routes (New York-Boston, Chicago-New York, Portland-Seattle) the subsidy is so large that it would be cheaper to sidetrack the trains and buy all the existing passengers *bus or plane tickets*. The Amtrak corporation negotiated a labor agreement providing up to six years full salary for employees who are furloughed. The liability for this stands at \$2.1 billion. If Amtrak goes bankrupt due to subsidy termination, the government's claim on assets could be easily relinquished to allow for payment of labor protection benefits, leaving the poor taxpayer to wait in line.

The Job Corps is the highest cost training program in the federal budget. Each one of the Job Corps 40,500 slots will cost the taxpayer \$15,200. The cost to the taxpayer equals the cost of a Harvard education, and is three times the annual cost of an education at the average four-year public university. Only one-third of Job Corps trainees are reported as employed within the year they leave the Job Corps. The Job Corps is considered only marginally better than the Comprehensive Employment Training Administration (CETA), which, generally recognized as a failure, was terminated with bipartisan support.

The new elevated rapid transit system in Miami was a

one billion dollar mistake. Ridership on the system is only about 10,000 per day—ten percent of what was originally forecast. It would have been cheaper to give each rider \$100,000! Most federally-funded systems cost between \$50 million and \$100 million per mile. The San Diego light rail system, completed without any federal subsidies, cost only \$6 million per mile. From 1970 to 1980, the use of public transit decreased from 8.9 percent to 6.4 percent of total work trips taken, yet federal support grew by 2,150 percent. Rarely have so many paid for the benefit of so few. Over the past ten years, mass transit costs have gone up 80 percent while fares have gone up by only 30 percent, causing a rising subsidy rate over time.

Worse, Federal subsidies, in many cases, benefit the middle and upper income riders and not the needy as is the case of the Washington Metro, 71 percent of whose riders have annual incomes of over \$20,000.

The cases above are only a small sample of the fiscal distortions that exist in the federal budget. A much larger sample is contained in the Office of Management and Budget (OMB) list of potential budget cuts for 1986 and beyond. OMB director David Stockman's comprehensive study, *Background on Spending Reforms in the FY 1986 Budget*, is a monumental testament to the blatant extravagance found within the federal budget. Hopefully, his study will be the blueprint for a serious effort to curtail the growth of federal spending.

WHEN WILL THE LIGHTS GO OUT?

by
Rajni Bonnie Ohri

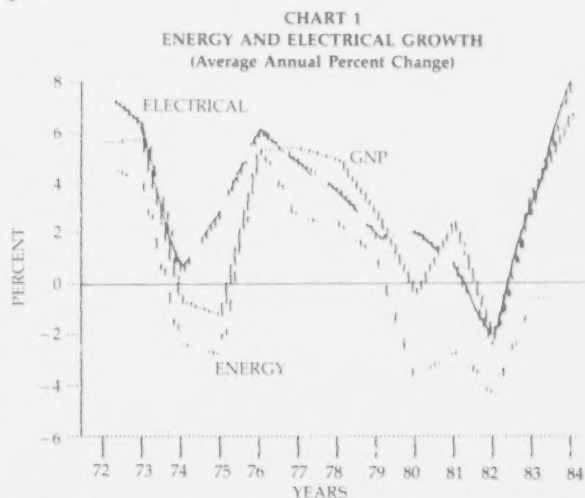
Before the end of the decade, in parts of the U.S., particularly the Northeast, the term 'electricity crisis' could very likely become as familiar as the term 'energy crisis' was in the 1970s. Currently, concern is being voiced among many forecasters in the electric utility industry that the U.S. could witness an electricity shortage by the 1990s. But others question this. Many industry officials are certain that no utility capacity shortage exists now or is likely to exist in the foreseeable future. The unexpected spurt in nationwide electricity usage in 1984, following several years of low growth, has added fuel to a growing debate over how to meet future electricity demand.

The combination of a revived economy and extreme weather resulted in the surprising 8.3 percent rise in electricity production in 1984, the highest annual increase since 1973. Industry officials acknowledge that the strong increase followed unusually depressed figures for 1982 and early 1983, when mild weather and recession so depressed electricity demand that production in 1982 actually fell by 2.4 percent, the first annual decline in the industry's history. Over the past two decades, regulators

and forecasters in the electric utility industry have consistently overestimated electricity demand. Expectations that power use would continue doubling every ten years, as it had in the 1950s and 1960s, led to an ordering binge for nuclear plants that turned into a flood of cancellations when economic growth, and thus, electricity demand fell in the late 1970s. Now, a new set of high-growth forecasters are predicting that another wave of heavy investment in electric generating plants, coal as well as nuclear, are necessary if an electricity crisis is to be averted by the end of the decade. They see electricity consumption growing in the four percent to five percent range. Others, questioning this assumption, predict growth in demand between zero and two percent a year throughout the rest of the decade.

Electric Utilities in the 1970s

During the 1970s, inconsistent economic policies, combined with sharp increases in the world price of oil, contributed significantly to inflation and lower economic growth in the U.S. But, throughout that period, electric generation out-performed both real economic growth and total energy growth (see Chart 1). Between 1973 and 1981, the real increase in the weighted price of energy was about 160 percent, while the real price of electricity increased by only 50 percent. Recessions in 1974-75 and 1980-81 held average economic growth between 1972 and 1981 to an annual rate of 2.7 percent. During the same period, total energy growth averaged about one percent while electricity production grew by three percent per year.



Source: Department of Energy, *Monthly Energy Review*, Statistical Abstract of the United States 1985.

Spurred by declining prices, electricity demand during the 1970s grew faster than gross national product (GNP), and public utility commissions were able to lower rates while keeping utility profits healthy. Encouraged by yearly growth rates as high as seven percent to ten percent in the early 1970s, and by the lure of cheaper electricity expected by a new generation of nuclear power plants,

utilities undertook massive building programs. The energy crisis also led them to believe that additional growth would stem from residential and industrial customers cut off from natural gas or eager to find a substitute for imported oil. Ever cheaper electricity was packed into everything, from home appliances to street lighting and industrial processes.

However, after 1974, rising fuel and construction costs pushed up real power prices faster than GNP. The economies of scale within the industry abruptly vanished as large new plants no longer meant gains in economic efficiency. In addition, concern over the environmental impact of conventional power plants increased, as did opposition to nuclear plants. This concern reached a fevered pitch in 1979 following the Three Mile Island incident. Since 1975, 85 planned nuclear generating plants have been abandoned at a cost of over \$16 billion. Further, as electricity prices began to rise, demand growth slackened. In fact, the demand for power proved surprisingly price-elastic—meaning that when rates went up electricity demand fell. That, in turn, led to severe financial problems for the industry and cancellations of planned power plants.

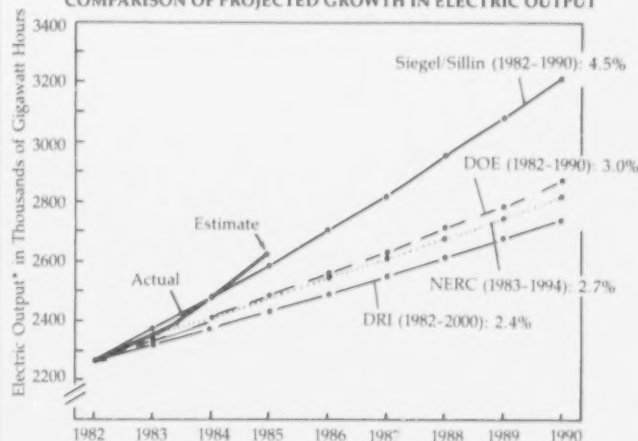
A near tripling of world oil prices in 1979-80 contributed, once again, to higher commodity prices, inflation, and a sharp downturn in economic activity. In 1980-81, economic growth averaged under one percent and total energy usage fell by 2.8 percent. Nevertheless, as in 1974-75, electric generation grew at a faster rate than economic activity and overall energy consumption. Throughout the remainder of the 1980s, real economic growth is expected to average four percent per year. If current economic conditions are sustained, electric load growth could increase above the three percent average of the 1973-81 period. Further, electricity is in a better price position relative to oil and natural gas than at any point in the last twenty years. This should enable electricity to penetrate the industrial and home heating markets which have been dominated by oil and natural gas since the 1950s.

Are Utilities Underforecasting?

Due to the sudden surge in electricity demand after years of low growth, uncertainty exists among utility forecasters regarding future growth (see Chart 2). Questioning the potential for faster economic growth, some utility forecasters have continued to reduce their projections. For example, the North American Electric Reliability Council (NERC), the official forecasting organ for the utility industry, issued a recent demand growth forecast of 2.7 percent per year from 1982 to 1990, which is lower than the Department of Energy's (DOE) projection of three percent per year. Among the utilities, the Edison Electric Institute (EEI) forecasts an average annual electricity growth rate of 2.5 percent for the rest of the decade; Com-

monwealth Edison recently lowered its official electricity forecast from three percent to two percent per year; and New England and Middle Atlantic utilities generally show electric growth projections of no more than one percent per year. While the faster growing Sunbelt regions are projecting more rapid rates of electricity growth than the rest of the country, the general forecasted increases in electricity have been significantly scaled back from earlier estimates.

CHART 2
COMPARISON OF PROJECTED GROWTH IN ELECTRIC OUTPUT



*Electric Output: Total electricity made available for consumption, for EEI "Total Source," Quarterly Report.

NOTE: Due to difficulties in identifying the first forecast year of each projection, and the fact that some projections are changed on an annual basis, 1982 was assumed to be the base year. Exceptions: NERC, whose base year was determined to be 1983; 1985 point is an estimate and assumes 6% growth.

Source: "Rethinking Utility Strategy under Conditions of High Growth," John Siegel and John Sillin, *Public Utilities Fortnightly*, September 13, 1984.

Data Resources, Inc. (DRI), projects modest electrical growth over the near-term. Increasing demand for electricity, albeit at a slower rate than that experienced in 1984, combined with weaker fuel prices, will result in an improved financial health for the electric utility industry. During the period 1982 to 2000, DRI forecasts a 2.4 percent rate of growth in electric output. According to Wharton Econometric Forecasting Associates, overall growth in electricity demand will barely reach three percent for the rest of the decade because cyclical industries such as metals, chemicals, paper, oil refining and cement, which account for over half of industrial power use, are expected to be in a downswing.

But, given the potential for sustained improvements in economic and financial conditions, why are electric load growth projections continuing to decline? For example, assuming an economic expansion consistent with our high growth scenario (see *ECONOMIC OUTLOOK Masters of our Destiny? Why Sustained Economic Growth is Possible*, October 1984), and a continuation of the historical relationship between economic growth and electrical demand, high growth forecasters John Sillin and John

Siegel, calculate a rate of growth in demand which greatly exceeds all current projections. They claim that the low growth bias in utility load planning generally occurs because of the following: a pessimistic view of regional and overall economic growth rates; little or no acknowledgement of the potential cross-elasticity effects resulting from the run-up in oil and natural gas prices; and an overestimate of the benefits of conservation and load management.

High growth forecasters predict demand for electricity will grow by four percent to five percent a year throughout the end of the decade—nearly double the industry's projections—leading to possible shortages of electricity supply by the 1990s. For example, if current trends continue through 1985, electricity sales in New York and New England will have increased by 15 percent since 1982, or nearly five percent a year. This compares with projections made in 1983 by regulatory and utility concerns which foresaw annual increases of only 1.8 percent for the same period. This high electricity demand during the 1980s is based on strong rates of economic growth and electricity's dramatically improved competitiveness, i.e., falling real electric prices and favorable demographic trends. The implications for our economy as a whole are significant. If higher electric growth is sustained, new plant and equipment commitments of at least \$1.5 trillion to \$2 trillion are required over the next ten years.

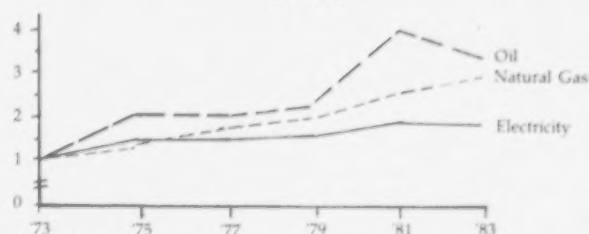
The High Growth Scenario

High demand for electricity in the 1980s is based on improved economic growth and market forces associated with electricity's dramatically improved price position relative to oil and natural gas. Sustained economic growth, averaging 3.5 percent to 4.5 percent per year versus the 2.2 percent of the 1973-82 period, is predicated upon the success of the Administration's economic policies—consistent monetary policies, lower tax and regulatory burdens, which encourage incentives to save and invest in new capital stock; stable or falling energy prices; increased productivity; and real income growth.

Electricity's greatly improved price position compared with oil and natural gas, and the likelihood that this will continue, is another reason that electricity demand will rise dramatically. Since 1973, electricity has improved its price position *vis-a-vis* oil and gas by 150 percent (see Chart 3). Consumers in New England, for example, paid the same real price for electricity in 1984 as they did in 1974. During the same period, however, real prices for heating oil and natural gas increased regionally by 40 percent and 100 percent, respectively. The nationwide 22 percent gain in electricity use since 1973, and 18 percent drop in gas and oil use enabled electricity to lift its domestic energy market share to 37 percent from 27 percent. Before 1973, electricity's penetration rate in the new home heating market was thirty percent nationally. Following

the 1973 run-up in oil prices, it jumped to fifty percent. Recently, that rate hit nearly seventy percent. As electricity becomes more price competitive *vis-a-vis* other sources of energy, the demand for it rises at the expense of those other sources, namely oil and gas. This so-called cross-elasticity effect more than offsets declines in demand due to any increases in the price of electricity. In effect, higher rates of electric growth, which lead to lower production costs, coupled with stable fuel prices should assure that real prices decline over the long term.

CHART 3
INDEX OF REAL ENERGY PRICES
(1973 = 1.0)



Source: Department of Energy, Monthly Energy Review.

Most high growth forecasters also assume that electricity usage moves in lockstep with GNP. The relationship between electric growth and GNP appears to be a nonlinear function of the magnitude of GNP—increasing with increasing levels of GNP. Between 1960 and 1972, when GNP growth averaged four percent, electricity growth was double that of GNP; between 1973 and 1982, when GNP growth averaged 2.2 percent, electricity growth averaged 2.5 percent, or about 1.1 times GNP growth. This has been the case over the last thirty years and appears to reflect increasing levels of new plant and equipment expenditures, a precursor of increased productivity and income. In periods of sustained economic growth, investment rates in new plant and equipment accelerate, resulting in a substitution of capital for labor, and increased energy usage. Further, in an improved economy, rising real income results in higher energy usage due to income elasticity effects. For example, from 1960 to 1972, real personal income grew by more than thirty percent. Each percentage point rise in real income is estimated to result in a similar increase in electricity use. However, from 1973 to 1982, real income increased by only five percent. In that period, the annual increase in capital spending averaged 1.1 percent, compared with an annual rate of 4.4 percent from 1960 to 1972.

Upturns in the ratio of electric load growth to GNP appear to lag new plant and equipment expenditures trends by about two years, which, in turn, lag economic upturns by 12 to 18 months. Thus, the current recovery could contribute to a further increase in the electricity demand to GNP growth rate ratio by 1986-87. In the 1980s, more favorable financial markets, incentives to invest and a labor force growing at one-third the rate of the past ten years, should accelerate capital investment, productivity, real income and electricity usage.

Fueling the Debate

The electric utility industry is clearly divided between high growth forecasts that predict a looming electricity crisis versus low growth forecasts that claim that the power shortage is a mirage. Low growth utility forecasters point to the fact that national averages indicate that the U.S. has substantial extra electricity capacity. Since the U.S. currently has a 40 percent reserve margin (20 percent is the minimum acceptable level), it will take at least eight years to use up our present excess capacity. But, these averages disguise wide regional disparities, and no 'national grid' yet exists to adequately link the supply-poor and supply-rich regions. At greatest risk is the rapidly growing Sun Belt. Indeed, if electricity demand grows at only two percent a year, DOE forecasts serious supply shortages in Kansas, Arkansas, Louisiana, Texas, California and parts of Missouri and Mississippi by the early 1990s. Also at risk are five Frost Belt states: Iowa, Minnesota, Nebraska, and North and South Dakota. In addition, as described in recent news reports, at its present rate of growth, Long Island, New York, may be just a year away from power disruptions. Nevertheless, the New York State Energy Department insists that the Shoreham nuclear plant is not needed.

In response to those forecasters who predict high growth in electric demand, many utilities have indicated that if shortages do occur, they will rely on a strategy of importing excess power from other regions. Given an outlook for higher growth, there are several reasons why the industry should question this strategy. First, it should be remembered that bulk power sales are usually for limited periods of time and generally give the seller the option to renegotiate should growth exceed expectations. Thus, power purchase agreements are typically directed towards addressing short-term capacity needs, but should not be excessively relied upon for the longer term. Second, it is not clear how much power will be available if importing turns out to be everyone's fallback strategy. For example, many east coast utilities indicate that they plan to purchase coal-fired power from the Midwest, thus eliminating the need to build additional capacity. But this strategy will not be viable if several utilities rely upon it at the same time. The same holds regarding proposed power purchases from Canada. The Northeast could import electricity from Canada, which has a surplus of power from its hydroelectric project in the James Bay. But the bulk of this power is sold on an 'interruptible' basis, meaning that the Canadian utilities have the right to cut off exports if the power is needed for domestic purposes. Third, a situation generally overlooked is that economic and electric growth tend to be parallel across regions, and in the case of Canada, across international boundaries. The Canadians have also been experiencing higher than anticipated growth in electric demand (5.5 percent a year in the last two years).

Thus, those who support the high growth forecast claim

that a shortage of electricity supply is possible in the near future, with demand beginning to exhaust supplies between 1988 and 1990. The implications are staggering. Assuming a 10-year lead time for licensing and construction, no plant retirements, a twenty percent reserve margin, and new plant commitments of 450 million to 700 million kilowatts, investment equaling \$1.5 trillion to \$2 trillion are necessary over the next ten years. This compares with an effective ordering rate of zero for the past ten years. Since 1978, no new nuclear plants have been ordered and all those ordered since 1974, with the exception of two, have been cancelled. Since 1982, only one new coal plant has been ordered. Moreover, many plans for new coal and/or nuclear plants, which account for almost seventy percent of electricity generation, have been shelved. In addition, the prospect of expensive electricity in short supply may deter industries from investing in new, productivity-enhancing technology, much of which is electricity-intensive. Such technology, which would also spur economic growth, ranges from electric arc furnaces for the steel industry and robotics for auto and machine-tool industries to advanced food-processing techniques and computer technology.

On the other hand, low growth utility forecasters essentially believe that electricity faces adverse trends. With supplies plentiful, the real price of oil and gas is likely to decline until at least 1990. Conversions to electricity will slow while the price of electric power drops little, since only one-sixth of the nation's power is generated with oil and gas. In addition, these forecasters claim that personal computers are rapidly displacing energy-intensive mainframes. The use of robots on assembly lines will also save on lighting and air-conditioning. And microprocessor controls are cutting into energy usage in appliances and industrial processes. Conservation has also helped to reduce electricity consumption by contributing to the development of power saving inventions. These include fluorescent bulbs that fit incandescent sockets and produce a pleasing light with three-quarters less power; refrigerators that consume 40 percent less power than the 1980 models, and electronic variable-speed drives that cut electricity use by industrial motors in half.

More important, 'rate shock' from new nuclear plants, both completed and cancelled, will increase electric rates. The costs of most of these reactors have yet to be reflected in rates. Spread over the next five years, the nuclear rate burden will lift average rates by two percent a year, enough to offset most of the normal spur to electricity use if the economy were to grow at three percent a year. Rate impacts will be twice that in New York, which has the nation's two costliest reactors, with New England following close behind. Thus, they argue, the ingredients of an electric boom are lacking.

Conclusion

The immediate concern of high growth forecasters is

whether the electric utility industry will continue to defer commitments of adding new generating capacity to coincide with realistic estimates of growth. In that case, increasing electricity prices beginning around 1990 and questions of electric utility reliability could begin to hamper electricity growth and hinder economic development as well as increase oil and natural gas consumption. Low growth forecasters, on the other hand, insist that electricity supplies are more than adequate to meet future needs. They argue that the industry should concentrate on plans to increase cogeneration (the same steam that is used for heat or industrial processes is also used to generate electricity) projects.

The policy implications of the high growth scenario are clear. If we are to continue to achieve healthy rates of economic growth, we must ensure that an electricity crisis is not looming in the near future. In effect, economic growth could be thwarted if there are inadequate supplies of electricity. Public policymakers need to take a hard look at the possible scenarios in the electric utility industry and the policy implications each one will have on economic growth.

TRENDS IN COMMERCE NOTES ON TABLE II MAY, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—The Department of Commerce's preliminary estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—indicates that the inflation-adjusted growth rate slowed to a seasonally adjusted annual rate of 1.3 percent in the first quarter. This is a significant downward revision from the flash forecast issued in March, which indicated a 2.1 percent growth rate. It is also about one-third below the 4.3 percent growth rate registered in the fourth quarter of 1984. The data continues to indicate that the consumer and business sectors have increased their spending, but these increases were offset by slowdowns in new home construction, federal purchases and in the level of exports.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.5 percent in March, resulting in a 9.6 percent (seasonally adjusted annual rate) rise in the money supply in the latest three-month period. This performance places the nation's money supply up 6.4 percent from its year-ago level.

Employment—The civilian unemployment rate remained unchanged at 7.3 percent in April for the third month in a row. Civilian employment—as measured by the monthly survey of households—decreased by 174,000 persons (seasonally adjusted), to 106.9 million, bringing the employment increase in the household survey in the last twelve months to over two and one-half million. In contrast, the number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 217,000 in April. This increase reflects the continued strength of service sector and construction employment. If working teenagers, in the 14 to 15 age group, are included in the Department of Labor data, then the actual number of persons employed exceeds 108 million.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.5 percent in March, following a 0.2 percent rise in January and a 0.3 percent increase in February. The source of the March increase was the gasoline and apparel components. This contrasted with the previous month when gasoline prices declined by 2.5 percent. Independent surveys by energy consultant Dan Lundberg show that gasoline prices have risen eight cents since February and are likely to rise another three or four cents before leveling off. This would indicate that gasoline prices will affect the consumer price index for at least the next two months.

Wholesale prices of finished goods rose 0.2 percent in March, the first increase of this year. The increase in finished goods prices was the result of a moderate rise in capital goods, women's and children's apparel, household furniture, and other consumer goods, while consumer foods prices continued to decline for the third month in a row. From March 1984 to March 1985, on an unadjusted basis, the finished goods index increased only 0.3 percent, the smallest increase for any 12-month period in 20 years.

The more volatile part of the Producer Price Index, crude goods, declined 1.2 percent in April, following decreases of 1.9 percent and 1.5 percent, respectively, in February and March. Crude materials prices in April were 8.3 percent below their levels of a year ago. Weak crude material prices appear to be a product of the strong dollar in international markets, and a surplus of farm products. Crude food and feedstuffs prices have declined nearly ten percent since the start of the year.

Housing Starts—Privately-owned housing units started in March jumped 16.2 percent, to an annual rate of 1,895,000, from the revised February rate of 1,631,000. This brought the increase over March of last year to nearly 12 percent. The surge in housing starts was mainly the result of a 54 percent increase in multi-unit starts, i.e. buildings with five or more units. The number of new single family starts was up 2.5 percent in March, the highest rate since April 1984. Building permits issued in

March were up 11 percent, reaching their highest level since June 1984.

Industrial Production—Industrial production advanced 0.3 percent in March, following a 0.2 percent decline in February. Production increases were apparent in most major categories of manufactured goods. The only exception was business equipment production which declined because of continued reductions in oil and gas drilling equipment.

The capacity utilization rate for manufacturing increased 0.1 percentage points in March as factories operated at 81 percent of capacity. Although the capacity utilization rate was at about the same level as a year ago, output has increased by 2.9 percent. This increase in output was due to a continued rise in available capacity as a result of the high level of investment.

Productivity—Nonfarm business productivity declined by 1.2 percent during the first quarter, the second such decline in the last three quarters. This decline in productivity resulted from an increase in jobs of over 800,000 in the first quarter, which amounts to a three percent annual rate of growth in employment, while the economy was growing at a 1.3 percent annual rate. The decline could also be a result of a faulty measure of GNP which will be revised upward in the coming months.

Interest Rates—At 10.5 percent, the prime rate has remained unchanged for nearly four months. Most interest rates rose during February and early March, but have since returned to their levels of late January.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicates that business failures continued to rise in mid-April and were about four percent above the level of a year ago. The index of business failures, which uses October 1983 as a base of 100, increased to 107.8 in the week ending April 12, 1985. This was four percent above the business failure index reported a year ago. However, the number of business discontinuances was 18 percent above the year-ago level. Between January and mid-April, the number of business discontinuances increased by five percent from its year-ago level. The recent rise in business failures is largely attributed to an increase in agricultural failures.

The latest available data indicates that new business incorporations in the first eleven months of 1984 rose by 6.3 percent. The number of new business corporations formed in November 1984 was 49,585, 3.5 percent more than the same month a year ago. Michigan and Georgia made the best showing, with increases of more than ten percent.

Federal Spending—The 'Federal Spending Index,' a

U.S. Chamber devised measure of the monthly change in federal expenditures, rose by 6.9 percent this March compared to its year-ago level. In the first six months of fiscal 1985, federal expenditures increased by 11 percent, about three times as fast as prices, indicating a real increase in federal spending of about eight percent from the year-ago level. Only one fifth of the increase is the result of a rise in defense spending. Receipts for the month of March were up 11.6 percent from the same month a year ago, partially as a result of the IRS delays in mailing out tax refunds. Since the federal government measures receipts on a net basis, receipts less refunds, preliminary estimates indicate that these delays have resulted in receipts appearing to be \$6.7 billion higher than they would have been if the refunds had been mailed on time.

Personal Savings—According to Department of Commerce data, personal savings declined to 4.6 percent of after-tax income in the first quarter of 1985, from 6.2 percent in the fourth quarter of 1984. The reason for the decline in the savings rate appears to be directly related to the delay in mailing out tax refunds, which consumers normally rely on at this time of year. The delays in the refunds reduced after-tax income by \$6.7 billion in February and March, which when translated into seasonally adjusted annual rates, amounts to over \$40 billion, on average, for each of the two months.

Retail Sales—The Department of Commerce reported that sales at the retail level rose by 0.9 percent in April, following a 1.9 percent decline in March. April retail sales were 4.5 percent higher than their year-ago level. Automobile sales rose by 1.6 percent, while department store sales saw a 1.9 percent gain.

Trade Deficit—The trade deficit, on a goods and services basis, increased to \$73 billion in the first quarter. The deterioration is the result of a \$5.8 billion decrease in first quarter exports while imports continued to increase by \$11.2 billion. The merchandise trade deficit decreased \$400 million in March compared to February. The decline in the deficit was the result of a 3.3 percent increase in the value of exports which substantially outpaced the 0.7 percent increase in imports. Surprisingly, there was a \$570.6 million increase in manufacturing exports for the month, hardly what one would expect after reading about the uncompetitiveness of American industry. The increase in manufacturing exports was mainly concentrated in office, advanced data processing and telecommunications equipment, and high-tech goods.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, decreased 0.2 percent in March, with seven of the ten available indicators down. This follows two months of strong showings by the leading indicators series. The index of coincident in-

**TABLE II
TRENDS IN COMMERCE**

			Previous		Percent Change From Previous	Percent Change From Year Ago
	Current Period	Period	Year Ago	Period		
Population (Millions)	Feb/85 238.1	238.0	236.0	0.1	0.9	
Gross National Product (\$B) [a]	I/85 3,819.9	3,758.7	3,553.3	1.6	7.5	
Gross National Product (72\$B) [a]	I/85 1,668.0	1,662.4	1,610.9	0.3	3.5	
Money Supply (M1) (\$B) [a]	Mar/85 571.9	569.3	537.3	0.5	6.4	
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures (\$B) [a]	Mar/85 2,441.5	2,454.6	2,273.2	-0.5	7.4	
Personal Consumption Expenditures (72\$B) [a]	Feb/85 1,093.3	1,085.9	1,040.4	0.7	5.1	
Disposable Personal Income (\$B) [a]	Mar/85 2,636.8	2,649.8	2,519.7	-0.5	4.6	
Disposable Personal Income (72\$) [a]	Feb/85 1,180.2	1,192.6	1,147.2	-1.0	2.7	
Personal Savings Rate (%)	Feb/85 4.6	5.1	6.1	-0.5[b]	-1.5[b]	
Civilian Employment (millions) [a]	Apr/85 106.9	107.1	104.4	-0.2	2.4	
Civilian Unemployment Rate (%) [a]	Apr/85 7.3	7.3	7.7	0.0[b]	-0.4[b]	
Average Hourly Earnings [a]	Apr/85 \$8.54	\$8.53	\$8.31	0.5	3.1	
Consumer Price Index (All Urban, 67=100)	Mar/85 318.8	317.4	307.4	0.5	3.7	
Purchasing Power of the Dollar (67=\$1.00)	Mar/85 0.313	0.315	0.325	-0.47	-3.54	
Prime Interest Rate (%)	Mar/85 10.5	10.5	11.2	0.0[b]	-0.7[b]	
Retail Sales (\$B) [a]	Mar/85 112.2	111.3	107.4	0.9	4.5	
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits (\$B)						
Before Tax	IV/84 228.7	224.8	225.5	1.7	1.4	
After Tax	IV/84 141.0	141.7	141.1	-0.5	-0.1	
Industrial Production (67=100) [a]	Mar/85 165.4	164.9	160.8	0.3	2.9	
Capacity Utilization Rate (Mfg.) (%)	Mar/85 81.0	80.9	80.9	0.1[b]	0.1[b]	
New Housing Starts (thou. units) [a]	Mar/85 1,895.0	1,631.0	1,700.0	16.2	11.5	
Net Business Formation (67=100)	Feb/85 118.0	117.3	117.2	0.6	0.7	
New Business Incorporations (Thousands) [a]	Nov/84 49.6	52.2	47.9	-5.0	3.5	
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100) [a]	I/85 162.9	160.0	158.3	1.9	2.9	
Unit Nonlabor Costs (77=100) [a]	I/85 161.0	160.3	152.2	0.4	5.8	
Producer Price Indices (67=100)						
Crude Materials [a]	Apr/85 311.3	312.9	339.4	-1.2	-8.3	
Intermediate Goods [a]	Apr/85 319.4	318.6	320.3	0.2	-0.3	
Finished Goods [a]	Apr/85 293.1	292.4	291.2	0.3	0.7	
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100) [a]	Mar/85 594.4	569.9	556.0	4.3	6.9	
Federal Government Debt Outstanding (\$B)	Dec/84 1,667.4	1,635.5	1,415.3	2.0	17.8	
INTERNATIONAL TRADE						
Exports of Goods & Services (\$B) [a]	I/85 361.4	367.2	358.9	-1.6	0.7	
Imports of Goods & Services (\$B) [a]	I/85 434.4	423.2	410.4	2.6	5.8	
Balance on Goods & Services (\$B) [a]	I/85 -73.0	-56.0	-51.5	30.4	41.7	
WHAT'S AHEAD?						
Index of Leading Indicators (67=100)	Mar/85 167.1	167.5	167.2	-0.2	-0.1	
NOTES: [a] Seasonally adjusted data						
[b] Percentage point difference						

dicators, a monthly approximation of aggregate economic activity, rose 0.5 percent in March, increasing for the first time in 1985.

SMALL BUSINESS OPINION POLL

The following are the tabulated results of a small business opinion poll taken at the 1985 Annual Meeting of the U.S. Chamber of Commerce. Although approximately 46 percent of the respondents said that the issues of taxes and federal regulation could pose a threat to the state of small business, a majority of those who responded said that the future of small business remained bright indeed. There were a total of 274 respondents to the survey. The figures in parenthesis next to each response represent the percent of respondents who supplied that answer. The answers to some questions may not add up to one hundred because of rounding, or because respondents were allowed more than one answer.

A. Compared to a year ago, is small business a greater or lesser force in the political arena?

- (49%) Greater
- (37%) Same
- (12%) Less

B. What are the major problems facing small business in the coming year? (Check only two)

- (44%) Taxes
- (15%) Availability of skilled employees
- (2%) Employee/customer crime
- (8%) Mergers/acquisitions
- (46%) Federal regulation
- (15%) State regulation
- (16%) Imports
- (37%) Interest rates
- (2%) Other

C. In five years, do you expect your business to be

- (68%) Larger
- (1%) Smaller
- (21%) About the same
- (1%) Disbanded
- (5%) Bought out by another business
- (1%) A publicly owned business

D. Does your organization provide goods or services to government?

- (5%) Federal only
- (12%) State/local only
- (26%) Both federal and state/local
- (51%) Do not do business with government

E. If you answered in question D that you do not do business with the federal government—why not? (Check all that apply)

- (13%) No needed product or service
- (13%) Government requires too much paperwork
- (9%) Government pays too slowly
- (2%) Don't know how
- (10%) Not as profitable as selling to the private sector
- (43%) Not applicable

F. Compared with five years ago, do you think consumers' attitudes toward business are: (Check as many as you wish)

- (45%) More aggressive in protecting their rights
- (34%) More aggressive regardless of right
- (18%) More sympathetic to a business point of view
- (15%) Have not substantially changed

G. How do you feel about the future of small business? (Check only one)

- (58%) Opportunities will increase
- (7%) Big business will eventually dominate everything
- (12%) Status quo will continue indefinitely
- (4%) Government will insure the survival of small business
- (12%) Government will regulate small business out of business
- (4%) No opinion

H. Do you agree that free market forces rather than federal price supports should set prices for farm commodities in the long run?

- (86%) Agree
- (7%) Disagree
- (5%) No opinion

I. Do you favor or oppose the Administration's proposal for a youth differential to the minimum wage, which would allow employers to hire teenagers at 75% of the minimum wage in the summer?

- (82%) Favor
- (10%) Oppose
- (7%) No opinion

J. If enacted, would your company hire new employees at the youth differential wage?

- (56%) Yes
- (26%) No
- (13%) No opinion